Securities Law Aspects of Equity Compensation

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Roy J. Schmidt*

OF THE **BUSINESS LAW SECTION**
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Mr. Schmidt is a partner in the Los Angeles Office of Gibson, Dunn & Crutcher LLP.

Federal Securities Laws

1. Exemption from Registration

a) Rule 701

(1) Applicable to Compensatory Benefit Plans. This rule of the Securities and Exchange Commission exempts from registration the offer and sale of securities issued to pursuant to a written compensatory benefit plan. The securities must be offered and sold by the issuer to employees, directors, consultants and advisors of non-public companies (i.e. companies that are not subject to the reporting requirements under the Securities Exchange Act of 1934) or their parents, majority-owned subsidiaries or majority-owned subsidiaries of their parents. If a company becomes subject to the reporting requirements of the '34 Act, it can still rely on Rule 701 for sales of securities previously offered, including the exercise of outstanding stock options.

(2) Limitation on Amount of Securities. The key restriction is on the number of securities that can be "sold" in any fiscal year of the issuer. Under Rule 701 as amended in April 1999, the number of shares sold in any twelve-month period must meet one of two limitations:

(a) the amount of securities sold or subject to options granted during the twelve-month period cannot exceed 15% of the number of shares of the same class outstanding as of the issuer's most recent balance sheet date (if no older than its last fiscal year end) or

(b) the aggregate sales price (exercise price in the case of options) cannot exceed the greater of $1 million or 15% of the total assets of the issuer measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end).

The 15% calculation for outstanding securities is made by treating all securities underlying currently exercisable or convertible options, warrants, rights or other securities (except those issued in reliance on Rule 701) as if they were outstanding. In applying the two tests, the issuer can use its last year-end balance sheet or its most recent balance sheet, at the issuer's election. During the 90 days after the end of a fiscal year the issuer can use a balance sheet from that prior year that is as of a date no more than three months before the end of the fiscal year. *See American Bar Association* (Available December 7, 2000).

(3) No Integration. Offerings under Rule 701 cannot be integrated with other offerings.

(4) Resale Requirements. Shares issued in this manner can be sold by the employee or other issuee only in the same manner as "restricted securities" can be sold under the SEC's Rule 144 under the Securities Act of 1933, which imposes certain current reporting, holding period, volume of sales, manner of sale and notice requirements. See below. However, ninety days after the issuer becomes subject to the reporting requirements of the Securities Exchange Act of 1934, non-affiliates can resell under Rule 144 without complying with any of these requirements except those relating to the manner of sale.

(5) Special Requirements for Consultants and Advisors. Consultants and advisors must be natural persons who have rendered bona bide services that are not in connection with the offer and sale of securities in capital raising transactions. Also, they must not directly or indirectly promote or maintain a market for the issuer's securities. Independent sales distributors can qualify as "de facto" employees if the sale of the issuer's products is their primary business activity and they derive a majority of their income from such sales. *See Wright Acquisition Holdings, Inc*. (Available August 2, 2000) and *Herff Jones, Inc.* (Available March 13, 2000, reconsidered August 1, 2000).

(6) Disclosure Requirements. Under the 1999 amendment to Rule 701, the issuer is required to make disclosures to the employee, including a summary of the material terms of the compensatory plan, risk factors and financial statements, before any "sale" of a security, but only if the aggregate sales price of securities sold or options granted (included at their exercise price) in any 12 month period exceeds $5 million. In the case of an option, this means before a reasonable time the exercise of the option. *See Morgan Lewis & Bockius LLP* (Available November 3, 1999.).

(7) Allows Limited Transferability. Rule 701 can also be used by family members of the employee, director, officer or consultant who acquire their securities by gift or through domestic relations orders.

b) Private Offerings/Regulation D

(1) Statutory Definition. Section 4(2) of the Securities Act of 1933 provides an exemption from the registration requirements of the Act for transactions not involving a public offering. Case law has established that a non-public offering is an offering made to a limited number of people who do not require the protection that registration under the Act would provide.

(2) Safe Harbor. Regulation D (Rules 501 through 508) provides a "safe harbor" for meeting the requirements of the Section 4(2) exemption. This means that if the offering meets the requirements of Regulation D it is exempt and if it does not meet the requirements it may or not be exempt under the case law that has developed under Section 4(2).

(3) Requirements for Safe Harbor. The Regulation D requirements for non-public offerings (see Rule 506) are:

(a) Specified information about the issuer must be provided.

(b) The issuer must exercise reasonable care to assure that the purchasers are acquiring the securities for their own account for investment and not with a view to distribution to the public.

(c) There can be no general solicitation or general advertising, and the number of purchasers cannot exceed 35 plus an unlimited number of "accredited' investors.

(d) Each purchaser who is not accredited must be sophisticated (i.e. have such knowledge and experience in financial matters that he or she is capable of evaluating the merits and risks of the investment).

(e) Sophistication can supplied by a purchaser representative who is sophisticated, unrelated to the issuer (subject to certain exceptions), discloses to the purchaser in writing a reasonable time prior to the sale of securities certain relationships to the issuer and is acknowledged by the purchaser in writing during the course of the transaction to be the purchaser's representative for the transaction. See Rule 501(h).

(f) "Accredited investors" include a number of institutions and other entities meeting particular requirements and also any natural person who:

(i) has a net worth or joint net worth with his or her spouse at the time of the purchase in excess of $1 million;

(ii) has had income in excess of $200,000 in each of the last two years or joint income with his or her spouse in excess of $300,000 in each of those years and a reasonable expectation of reaching the same income level in the current year; or

(iii) is a director, executive officer, or general partner of the issuer or a director, executive officer or general partner of a general partner of the issuer. See Rule 501(a).

(g) A notice should be filed with the Securities and Exchange Commission Failure to file the notice does not affect the availability of the Regulation D safe harbor, but the safe harbor is not available if the issuer or any of its predecessors or affiliates have been temporarily, preliminarily or permanently enjoined for violating the requirement that the notice be filed. See Rules 503 and

507.

(h) Failure to comply with a requirement of Regulation D does not result in loss of the exemption from registration for an offer or sale to a particular person or entity if the failure to comply did not relate to a requirement that was intended to protect that person or entity, the failure to comply was insignificant with respect to the offering as a whole and a reasonable attempt to comply was made. See Rule 508.

c) Small Offerings/Regulation D

(1) The Statutory Exemption. Section 3(b) of the Securities Act of 1933 authorizes the SEC to exempt from registration "small" or "limited" public offerings by adopting rules defining the terms of the exemption, provided that the aggregate offering price of the securities in the offering does not exceed $5 million. This is the same statutory authority under which so-called "Reg A offerings " are made.

(2) Offerings Up to $1 Million. Pursuant to the authority under Section 3(b) of the Act, the SEC adopted Rule 504 of Regulation D. It exempts offerings of up $1 million less the amount of all offerings within twelve months prior to the commencement of the 504 offering or during the 504 offering in reliance on any exemption under Section 3(b) of the '33 Act and all offerings made in violation of the registration requirement of the '33 Act. Importantly, there is no specific requirement as to the information that must be disclosed or the sophistication or accreditation of the investors. The SEC can do this because the roots of the exemption are in Section 3(b) of the '33 Act, which applies to small or limited public offerings, and are not in Section 4(2) of the Act, which requires that the offering not be public.

(3) Offerings Up to $5 Million. Rule 505 of Regulation D provides another exemption based on Section 3(b) of the Act. It applies to offerings up to $5 million, has similar aggregation rules to determine if that limitation has been satisfied, requires the disclosure of specified information to investors and requires that there be no more than 35 purchasers (excluding accredited investors). The 35 purchaser requirement can be waived by the SEC, although such waivers are not commonly sought. A key point is that there is no requirement that the investors be sophisticated or accredited, again because Rule 505 has its roots in Section 3(b) of the Act instead of Section 4(2).

(4) No Bad Actors. Another important limitation on the use of the Rule 505 exemption is that the issuer, any of its predecessors or any its affiliates cannot be involved in designated legal proceedings involving violations or alleged violations of the federal securities laws. See Rule 262.

d) Integration of Offerings

(1) The Meaning of Integration. The requirements of Section 4(2) of the Securities Act of 1933 and of Rules 504, 505 and 506 require that the "offering" meet certain requirements as to the dollar amounts or the number or kind of investors involved. This makes it essential to determine when one offering ends and another begins or, in securities law vernacular, when the offerings will be "integrated."

(2) Safe Harbor. Guidance as to when offerings will be integrated is provided by Rule 502 (a), which provides a very useful safe harbor. If more than six months has expired after the completion of a Regulation D offering before the commencement of another Regulation D offering, the two offerings will be treated as separate offerings. Also offerings under employee benefit plans and generally offerings made outside the United States will not be considered part of a Regulation D offering.

(3) Outside the Safe Harbor. If the six month rule is not satisfied, significant uncertainty can arise as to whether offerings will be integrated. Rule 502(a) and Release No 33-6863 of the SEC say that integration depends on the facts and circumstances. Factors to be considered include:

(a) Whether the sales are part of a single plan of financing;

(b) Whether the sales involve the same class of securities;

(c) Whether the sales have been made at or about the same time;

(d) Whether the same type of consideration is received; and

(e) Whether the sales are made for the same general purpose. See SEC Release No. 33-4552.

There is no guidance as to how these factors are to be weighted, and the application of the standards in a particular case can be quite uncertain. Lawyers should not lightly advise their clients to venture outside the safe harbor.

(4) Special Problems with Options. Because outstanding options constitute a continuing offer of the underlying securities (at least once the options have become exercisable) and because options are typically offered under plans, it is possible that the offering and sale of all of the securities under a particular plan will be integrated with each other. Offerings under different plans may also be integrated with each other if the integration factors set forth above so indicate. Option plans can be structured to comply with the six-month safe harbor by limiting the exercise periods, but this comes with a loss of flexibility and valuable rights for the option holder. See SEC No Action Letter Mosaic Technologies (Available September 21, 1984).

(5) Definition. Securities issued under Section 4(2) of the Securities Act of 1933 are "restricted securities" (see Rule 144), and securities issued in reliance on Rule 701 or Regulation D have the status of restricted securities.

(6) Resales Two Years After Acquisition. Restricted securities cannot be sold freely until they have been held for two years after they are acquired (subject to certain exceptions). If the securities are purchased, the two year period does not begin to run until the full purchase price is paid (subject to certain exceptions). This two-year holding period does not apply to a shareholder who is an affiliate of the issuer at the time of resale or has been such an affiliate within three months prior to the resale. See Rule 144(k).

(7) Resales One Year After Acquisition. Restricted securities issued by public companies can also be sold after one year if the following requirements are met:

(a) The issuer has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 90 days and has filed all reports required to be filed (i.e. annual Reports on Form 10-K, Quarterly Reports on Form 10-K and Current Reports on Form 8-K) for the last 12 months or such shorter period as the issuer has been subject to the reporting requirements. See Rule 144(c)(1). For issuers not subject to those reporting requirements, certain other requirements must have been satisfied. See Rule 144(c)(2).

(b) The number of securities sold in any three month period cannot exceed the greater of 1% of the number of shares or other units of the security outstanding or the average weekly trading volume for the security for four calendar weeks preceding the placing of the order to sell (subject to certain exceptions). See Rule 144(e).

(c) The securities must be sold in a normal "broker's transaction" (as defined in Rule 144(g) or directly to a "market maker" and the person selling the securities may not engage in certain kinds of solicitation of buyers or pay any consideration other than to the broker who executes the transaction. See Rule 144(f). Retail brokerage companies are familiar with these requirements and have established procedures to satisfy them.

(d) If the transaction involves more than 500 shares or other units or an aggregate purchase price of more than $10,000, a Form 144 must be filed with the SEC. See Rule 144(h).

e) Intrastate Offerings

(1) Statutory Basis. Section 3(a)(11) of the Securities Act of 1933 and Rule 147 of the SEC exempt intrastate offerings, but the requirements for such offerings are so strict that this exemption is almost never relied upon.

(2) Requirements to Meet. The securities must be offered and sold within a single state by an issuer which is organized under the laws of that state or, in the case of a partnership or other entity that is not organized under any state law, has its principal office in that state and the issuer must derive at least 80% of its revenues from the operation of a business or of real estate in the state or the rendering of services in the state, must have at least 80% of its assets in the state and must intend to use and use at least 80% of the proceeds from the offering in connection with the operation of a business or of real estate in the state or the rendering of services in the state (all as determined in accordance with Rule 147(c)). The offers and sales must be made only to persons resident in the state (as defined in Rule 147(d)).

(3) Integration. There is a safe harbor against integration with offerings under Sections 3 and 4(2) of the Act and offerings registered under the Act if they are completed more than six months before or commence more than six months after the intrastate offering.

(4) Resales. Resales of securities in reliance on the interstate offering exemption within nine months after the last sale in the offering must be made to persons in the same state.

f) When does the Sale Occur?

(1) The Underlying Stock. Under Section 2(a)(3) of the Securities Act of 1933 the grant of an option to purchase shares of stock is not an offer of the underlying stock until the option becomes exercisable. The exercise of the option clearly involves a sale of the underlying security.

(2) The Option Itself. The option itself is a separate security, but the SEC staff has traditionally taken the view that the grant of the option is not a sale but merely an offer of the underlying security once the option becomes exercisable. As a result, it is not uncommon for issuers to grant options before they have registered the underlying securities and not to register the options themselves.

2. Registration Under the Securities Act of 1933

a) Form S-8

(1) The Basics of the Form. This a simple form of registration for securities of public companies offered pursuant to employee benefit plans. The form incorporates filings under the Securities Exchange Act of 1934 for a description of the issuer's business and does not require the filing of a form of prospectus, as do other forms of registration statements. S-8's become effective upon filing (see Rule 462(a)), and are rarely if ever reviewed.

(2) Securities That Can Be Registered. "Employee benefits plan" includes plans that benefit employees and in addition directors, officers, consultants, advisors and general partners, in each case of the issuer or its subsidiaries or parents. For purposes of the exercise of stock options and the sale of the underlying securities and for certain intra-plan transfers, S-8 registration statements can also be used for securities held by people who formerly served as employees, directors, officers, consultants, advisors or general partners of the issuer and the executors, administrators and beneficiaries of any such persons who are deceased and personal representatives of any such persons who are legally incompetent. Consultants and advisors must be natural persons who render *bona fide* services not in connection with the offer or sale of securities in capital-raising transactions. Also, they must not directly or indirectly promote or maintain a market for the issuer's stock.

(3) Requirements As To Issuer. The issuer must have been subject to the reporting requirements of the Securities Exchange Act of 1934 immediately prior to the time of filing the registration statement on Form S-8 and must have filed all such reports required to be filed during the prior 12 months (or such shorter period as the issuer has been subject to such reporting requirements).

(4) Disclosure Requirements. The issuer is required to deliver to plan participants material information regarding the plan and its operations that will enable participants to make an informed decision regarding investment in the plan. The information can be in one or several documents provided it is presented in a clear, concise and understandable manner. Many companies use a prospectus format which includes a description of the plan, the tax consequences and a description of the underlying securities.

(5) Updating Information. Since the S-8 registration statement is a "shelf" registration which is intended to be relied for many months or several years, it is updated to reflect developments in the issuer's business by the filing of '34 Act reports, which are incorporated by reference.

(6) Resale Transactions. Form S-8 can also be used to register for resale securities already issued in situations where the securities are held by affiliates or constitute or are treated as restricted securities because they were issued in reliance on Section 4(2) of the Securities Act of 1933 or Regulation D or Rule 701. If the issuer has been subject to the '34 Act reporting and proxy solicitation requirements for less than 12 months or is a foreign issuer or otherwise does not meet the requirements for filing a registration statement on Form S-3 or F-3 (applicable to certain offerings of certain foreign private issuers), then resales using the prospectus must meet the volume limitations of Rule 144(e) discussed above.

b) Limited Transferability.

(1) Transfers to Family Members and Related Entities. Effective April 7, 1999 Form S-8 was amended to relax a requirement that employee benefit plan stock options be nontransferable except under the laws of descent and distribution. Now options can be transferable to family members (as defined) which includes, in addition to a broad range of family members, any person sharing the same household (provided they are not tenants or employees), former spouses, trusts in which family members have more than a 50% beneficial interest, a foundation in which family members (and the employee) control the management of the assets and any other entity in which they hold a majority of the voting interests. Transfers from one family member to another are also permitted.

(2) Restrictions on Transfers for Value. The options cannot be transferred for value except in connection with a domestic relations order in settlement of marital property rights or a transfer to an entity in which more than 50% of the voting interests are owned by family members and the employee in exchange for interests in that entity.

(3) Benefits of Transferability. Being able to transfer a stock option has significant estate planning advantages because it enables to option holder to transfer an asset that may appreciate significantly at a time when its value for gift tax purposes is relatively low. The increase in the value of the underlying stock after the option is granted and transferred benefits the transferee without any further gift or estate tax.

(4) Consequences of Transfer. Taking advantage of the limited transferability provisions involves some complications:

(a) The options will not qualify for the special tax treatment afforded incentive stock options under the Internal Revenue Code.

(b) The tax payable upon exercise of the option (including withholding tax) is payable by the original option holder even though the transferee gets the benefit of the income being taxed.

(c) If the original option holder decides to leave his or her employment, the transferee can lose the benefit of the option.

(d) If the original option holder is the chief executive officer or one of the five most highly compensated executive officers of the issuer, the option and any gain realized upon exercise is still reported as compensation in the issuer's proxy statement and '33 Act registration statements even though the transferee gets the benefit of the gain.

(e) The issuer must deliver the disclosure materials constituting the prospectus required by Form S-8 to the transferee. The transferor is not obligated to do so. The disclosure material must include a discussion of the estate and gift tax consequences to the option holder of a transfer of an option. See SEC Release No. 33-7646.

c) Registration Status of Section 423 Stock Purchase Plan Interests. Some issuers register plan interests (as well as the stock to be purchased) under the '33 Act using Form S-8. The SEC staff has not given definitive advice as to whether this is required. Such registration also suggests that the plan would then have to report under the '34 Act on Form 11-K, a question the staff reportedly has under advisement. Common practice is not to register the plan interests and not to file 11-K reports, although a recent survey showed that 21% of companies do register their plan interests and file 11-K reports. *See Corporate Counsel,* November-December 2000 issue, p. 10.

3. Short-Swing Profits Under Section 16(b)

a) How Section 16(b) Works

(1) Capturing Short-Swing Profits. Section 16(b) of the Securities Exchange Act of 1934 is intended to combat trading based on inside information by requiring officers, directors and persons owning beneficially 10% or more of any class of outstanding securities of a public company to pay over to the issuer any "profit" realized as a result of purchases and sales of securities of the issuer within the same period of six months. "Profit" is defined as any difference between the net proceeds of the sale and the price paid for the purchase. The sale transaction can even precede the purchase transaction as long as both occur in the same six month period.

(2) No Proof of Inside Information. The critical aspect of Section 16(b) is that there is no requirement of proving that the security holder had any inside information or that the purchase and sale transactions were related to each other in any way. It is enough that the person was an officer, director or 10% security holder and had a buy and a sell transaction in the same six month period.

(3) Enforcement. Section 16(b) is vigorously enforced by members of the private bar who monitor the filing of stock ownership reports described below and sue derivatively if the issuer does not take action upon their demand. **This is one area of the securities law where violators almost always get caught.**

b) The Concept of Derivative Securities

(1) The Grant of a Stock Option As a Purchase. Under the SEC's rules an option is a so-called "derivative security" because it involves "an exercise privilege at price related to an equity security . . . with a value derived from an equity security." See Rule 16a-1(c). For purposes of the short-swing profit provision of Section 16(b), acquiring a stock option is a "purchase" of the underlying security, and disposing of stock option is a "sale " of the underlying security. See Rule 16b-6(a).

(2) Unexpected Short-Swing profits. This means that, unless there is an applicable exemption, the granting of a stock option is a purchase of the underlying stock which can be matched with a sale of shares of the same stock occurring within six months of the grant, resulting in a so-called short-swing profit recoverable by the issuer. Likewise, the sale of stock within six months of the grant of an option to purchase the same class of stock can also result in a short-swing-profit (unless an exemption is available).

(3) The Exercise of An Option Is Not a Purchase. The exercise of a stock option is a non-event for purposes of Section 16(b) because the "purchase" is deemed to have occurred when the option was granted. There is an exception to this rule for situations where the option is exercised even though the exercise price exceeds the market value of the security being purchased, an event which should not occur unless something highly unusual is going on. See Rule 16b-6(b).

(4) Expiration of the Option. The cancellation or expiration of a stock option without its having been exercised is not a "sale" as long as no consideration is received in connection with the cancellation or expiration (which is normally the case with employee stock options). See Rule 16b-6(d).

(5) Why Derivative Securities? These counter-intuitive rules were developed to deal with the emergence of markets for "put" and "call" options and other more sophisticated derivative instruments, which enable one to benefit from trading on inside information without ever owning the underlying security.

c) Exemption for Employee Benefit Plans

(1) Rationale for Exemption. Since employee benefit plans typically involve acquisitions of securities from the issuer, there is little danger that the purchaser would have information material to the value of the securities that the issuer does not have. As a result there is a rather broad exemption from the short-swing profit provisions of Section 16(b).

(2) Requirements for Exemptions. Grants, awards and other acquisitions from the issuer are exempt if:

(a) the specific transaction is approved by the board of directors of the issuer or a by a committee of the board composed of two or more directors who are not employees of the issuer and do not have certain consulting or other business relationships with the issuer; (see Rule 16b-3(d) and (b)(3)); or

(b) the specific transaction is approved by the vote of the holders of a majority of the outstanding voting shares present in person or by proxy at a stockholder's meeting or by written consent of the holders of a majority of the outstanding voting shares; or

(c) the equity securities are held for six months or more or, in the case of an option, six months or more elapse from the date of grant to the date of transfer of the option or the underlying shares (exercise of the option not being a transfer of the option for this purpose). See Rule 16b-3(d)

(3) Sales to the Issuer. Transactions involving disposition of securities to the issuer are also exempt if the disposition is approved in advance by the board of directors or a committee of the board involving outside directors as described above or by a vote of the stockholders described above. See Rule 16b-3(e).

(4) Discretionary Transactions. Different requirements apply to the exemption of "Discretionary Transactions," which (subject to certain exceptions) are transactions which occur at the volition of the plan participant and result in intra-plan transfers involving an issuer equity securities fund or a cash distribution funded by a volitional disposition of an issuer equity security. An example of this would be a transfer pursuant to a benefit plan which allows the employee to switch from a fund invested only in the issuer's common stock to a fund invested in other securities, such as a diversified mutual fund.

(5) Requirements for Exemption. Discretionary Transactions involving an acquisition of issuer equity securities are exempt from Section 16(b) only if the election to engage in that transaction was made at least six months after any previous election to engage in a transaction involving a disposition of issuer equity securities. Likewise, transactions involving dispositions of issuer equity transactions are exempt only if the election to engage in the transaction is made at least six months after any previous election to engage in a transaction involving an acquisition of issuer securities. See Rule 16b-3(f).

d) Using Outstanding Shares to Pay the Exercise Price

(1) Need for the Exemption. Some stock option plans allow the optionee to pay the exercise price of a stock option by surrendering outstanding shares already owned by him or her and receiving credit toward the purchase price equal to the market value of the shares surrendered.

(2) Applicable Exemptions. On its face this would seem to involve a simultaneous purchase and sale of stock, but there is no short-swing profit because the exercise of the option is not a purchase under the derivative security concept and because dispositions of equity securities to the issuer are exempt under Rule 16b-3(e).

e) Dispositions of Options in Business Combinations.

(1) Applicable Exemptions. In a business combination outstanding options can be canceled for or converted into cash, debt, equity securities or a combination of any of them or the options can become exercisable to purchase stock of the acquiring company or be exchanged for a substitute option to purchase stock of the acquiring company. On its face each of these transactions would seem to involve a sale of the underlying securities. Not so for purposes of Section 16(b). In each case the transaction is considered to involve disposition of the securities to the issuer and therefore exempt, but only if the transaction is approved by the board of directors of the target company, a committee of that board meeting the requirements as to independence described above or by the vote or written consent of the stockholders of the target company as described above.

(2) Approval Required. The approval of the board or committee must be specific as to the names of the options holders, the number of shares and terms of the options involved and that the approval is being given for the purpose of getting the exemption under Rule 16b-3. The proxy statement for any stockholder approval should describe the security holdings of each officer as to which approval of the exemption is sought, and the proxy card and proxy statement should say that the vote will result in the exemption from Section 16(b). See SEC Release No. 34-37260 and SEC No Action Letter Skadden Arps, Slate, Meagher & Flom (Available January 12, 1999).

f) Stock Purchase Plans. Transactions pursuant to a stock purchase plan meeting the requirements of Section 423 of the Internal Revenue Code are exempt under rule 16b-3(c) without condition. However, sales of shares purchased under such a plan are not exempt unless made to the issuer and approved as required by Rule 16b-3(e). Option rights under 423 plans are not derivative securities if the price is not fixed until the end of the offering period. See Release No. 34-28869 n.147

g) Restricted Stock. The issuance of restricted stock is exempt under Rule 16b-3(d), the lapse of restrictions is a non-event, the re-purchase of the shares by the issuer is exempt under Rule 16b-3(e) and the sale of the shares is not exempt. Restricted stock does not involve a derivative security (like an option) because it is not convertible or exercisable for any other security. See Release No. 34-1814 Q. 88(d) as amended by Release No. 34-28869 § VIII(C).

4. Reporting Requirements Under Section 16(a).

a) Reports Required. The SEC's Rules 16a-1 through 16a-13 establish a regimen for officers, directors and 10% stockholders to report their beneficial ownership of equity securities of the issuer and changes in that beneficial ownership. Initial reports must be filed on Form 3, certain changes in beneficial ownership must be reported on Form 4 within 10 days after the end of the month in which the change occurs and ownership at year end must reported on Form 5 unless all transactions that would have been reported have been reported before the Form 5 is required to be filed. See Rule 16a-3.

b) Treatment of Options. Any grant, award or other acquisition of an equity security from the issuer that is exempt from the short-swing profit provisions of Section 16(b) does not have to be reported as a change in beneficial ownership on Form 4. If not voluntarily reported on Form 4, however, such a transaction would have to be reported after year-end on Form 5. The exercise or conversion of derivative securities, which includes the exercise of a stock option, is an exception to this general rule and does have to be reported on Form 4 even if it is exempt from the short-swing profit provisions of Section 16(b) as described above. The expiration of a stock option without being exercised does not have to be reported on Form 4 but, if not so reported, would have to be reported on Form 5.

c) Treatment of Stock Purchase Plans. Transactions under stock purchase plans are exempt from the 16(a) reporting requirements under Rule 16a-3(f)(1)(i)(B). However, the sale of stock acquired under such a plan would trigger a Form 4 filing requirement.

d) Treatment of Restricted Securities. The treatment of restricted securities is the same as for stock options if the grant is exempt from 16(b) under Rule 16b-3. Vesting is not reportable, and forfeiture is also not reportable on Form 4 but would have to be reported on Form 5. The sale of the shares would have to be reported on Form 4 unless the sale is made to the issuer and is approved as required by Rule 16b-3(e).

e) Disclosure Requirements. Proxy statements and registration statements on Form S-1 require the disclosure of extensive information about the compensation of the chief executive officer of the issuer and the other four most highly compensated executive officers, including:

> (1) the number of shares subject to restricted stock awards, stock options, stock appreciation rights and any other long term compensation arrangement involving equity securities, in each case to the extent granted during the last full fiscal year (determined on an accrual basis);
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> (2) the potential realizable value of stock options and free standing stock appreciation rights granted during the year based upon assumed 5% and 10% compounded annual appreciation in the value of the shares or the present value of the option determined under an option pricing model, which may include the Black-Scholes model;
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> (3) the number of shares acquired during the year upon exercise of stock options and stock appreciation rights and the dollar amount realized as a result; and
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> (4) the number of shares underlying outstanding stock options and stock appreciation rights held at the end of the year (showing separately those that were exercisable and those that were not) and the aggregate spread between the market value of the securities underlying all outstanding stock options and stock appreciation rights that are in-the-money and their aggregate exercise price.

5. Margin Rules

a) Basic Requirements. Regulations adopted by the Board of Governors of the Federal Reserve System pursuant to Section 7 of the Securities Exchange Act of 1934 require that credit extended to acquire margin securities must not exceed 50% of the market price of the securities securing the loan. Margin securities are securities that are listed or admitted for unlisted trading privileges on any national securities exchange or that trade on the Nasdaq Stock Market, which includes both the Nasdaq National Market and the Nasdaq SmallCap Market.

b) Exemption for Employee Plans. Regulation U of the Board of Governors exempts credit transactions under employee stock option, purchase or ownership plans from the usual margin requirements if the plan is approved by the stockholders and the loan is not made for more than the amount of the current value of the collateral which a lender, exercising sound judgment, would lend without regard to the borrower's other assets held as collateral in unrelated transactions. See 12 C.F.R.§ 221.4. In practical terms this probably means that the issuer cannot lend the option holder more than half of the market value of the shares, which could be enough to pay all or a substantial portion of the exercise price of the options.

c) Registration Requirement. If the amount of margin loans made by an issuer exceeds $200,000 during any calendar quarter or the amount of such loans outstanding at any time during the calendar quarter exceeds $500,000, the issuer will have to register with the Board of Governors. See 12 C.F.R. § 221.3(b).

d) Cashless Exercises

(1) The Need for a Solution. For the typical employee the most likely source of funds to pay the exercise price of a stock option is the proceeds of the sale of shares purchased upon exercise. Until 1988 this presented a problem because of the effect of the margin rules on credit extended to bridge the gap.

(2) How the Broker Does It. Now a broker can handle a so-called "cashless exercise" of a stock option if the securities are to be issued pursuant to an employee benefit plan registered on Form S-8. The option holder delivers the broker an irrevocable notice addressed to the issuer exercising the option and directing delivery of the shares to the broker. The broker is permitted to treat receipt of the notice as immediate delivery of the securities, which means that no credit is being extended for which a margin must be maintained. See 12 C.F.R. § 220.3(e)(4). The broker then lends the customer the exercise price by delivering it to the issuer, while selling some of the option shares in the market to repay the loan. Alternatively the broker can lend the option holder the shares to be sold by selling shares of the same class and remitting the proceeds to the issuer as the exercise price. In either case the issuer must concur in the arrangements and the mechanics must be set up in advance.

6. Repricing of Options and Tender Offer Rules

The staff of the SEC is reportedly considering whether an offer by an issuer to exchange new options or cash or restricted securities for outstanding options is a tender offer subject to Rule 13e-4 and requiring the filing of a Schedule TO. Several companies have complied with the tender offer rules in these kinds of exchange offers.

B. State Blue Sky Laws

1. Federal Preemption. In 1996 the National Securities Markets Improvements Act amended Section 18 of the Securities Act of 1933 to preempt the registration and qualification provisions of state blue sky law with respect to:

a) securities listed on the New York or American Stock Exchanges or the Nasdaq National Market of the Nasdaq Stock Market and

b) securities issued under the exemption afforded by Rule 506 to non-public offerings to up to 35 sophisticated investors and an unlimited number of accredited investors if certain other requirements are met (see discussion of Rule 506 above).

Federal preemption may not apply to options or other plan interests with respect to listed securities, and therefore it may be necessary for issuers to find another exemption for the options or plan interests themselves.

2. Which State's Law Applies. Generally the blue sky law of a state is implicated if the offer or sale occurs in the state. This means that an issuer has to be prepared to deal with the law of the state where its principal office is located as well as the law of each state where any plan participant works or lives. Also care should be taken not to make offers or sales in totally extrinsic states, such as the state of the resort where the executive retreat is held.

3. Common Exemptions

a) Listed Company and Nasdaq NMS Exemptions. Many states exempt shares listed on the New York and American Stock Exchanges and on the Nasdaq National Market, and these exemptions also typically include any warrant or right to purchase or subscribe to the listed security. California has a listed company exemption which covers the New York Stock Exchange, the American Stock Exchange (excluding the Emerging Company MarketPlace), Tier I of the Philadelphia Stock Exchange and the Nasdaq National Market. See Corporations Code Section 25100(o) and Department of Corporations Release Nos. 27C, 96C and 87C.

b) Exemptions for Stock Benefit Plans. Many states have exemptions for grants of stock options and stock purchase rights under employee benefit plans, and many of these statutes clearly apply to the issuance of the underlying shares as well. One trap for the unwary is that some of these exemptions apply only if an employee is involved, as opposed to a non-employee officer or director or a consultant or adviser.

c) Section 25102(o) in California

(1) Requirements for Exemption. Section 25102(o) of the California Corporate Securities Law exempts the offer and sale of any security pursuant to a stock purchase plan or agreement or stock option plan or agreement if:

(a) the security is exempt under the SEC's Rule 701 (see discussion above),

(b) the plan or agreement conforms to certain regulations adopted by the Commissioner of Corporations, and

(c) a notice is filed within 30 days after the initial issuance of any security under the plan accompanied by a filing fee.

(2) The Regulations Applicable to Options. The regulations of the Commissioner of Corporations which must be complied with are

Sections 260.140.42, .45 and .46 for stock purchase plans and agreements and 260.140.41, .45, and .46 for stock option plans and agreements, in each case of Title 10 of the California Code of Regulations. For options these regulations require, among other things, that:

> (a) The options be issued pursuant to a plan which limits the number of shares subject to outstanding options, together with shares provided for under stock bonus or similar plans of the issuer, to 30% of the number of outstanding shares excluding shares subject to promotional waivers, although the 30% limit can be exceeded if doing so is approved by the holders of two-thirds of the outstanding shares entitled to vote. The 30% limitation is determined by assuming the conversion of outstanding convertible preferred and senior common stock.
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> (b) The exercise price must be not less than 85% of the value of the stock at the time the option is granted, except that the price must be 110% of the fair value in the case of a grantee who owns stock having more than 10% of the total combined voting power of all classes of stock of the issuer or its parent or subsidiary corporation. This requirement precludes reliance on Section 25102(o) for restricted stock, where the purchase price is typically nominal.
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> (c) The option must become exercisable at the rate of at least 20% per year over five years from the date of grant, subject to reasonable conditions such as the continuation of employment. For options granted to officers, directors or consultants, however, the options may become exercisable subject to reasonable conditions at any time during any period established by the issuer.
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> (d) The issuer must provide the option holder financial statements at least annually unless the issuance is limited to key employees whose duties assure them access to equivalent information.

(3) The Regulations Applicable to Purchase Plans. For stock purchase plans and agreements the requirements are comparable but not identical.

(4) Applicability to Limited Liability Company Options. Section 25102(o) was amended, effective January 1, 2001, to make the exemption available for stock purchase plans and agreements and stock option plans and agreements of limited liability companies. Also effective January 1, 2001 the Department of Corporations adopted emergency amendments to the regulations referred to in Section 25102(o) to make them applicable to such plans and agreements of limited liability companies. These regulations are effective for 120 days during which the Department has announced that it will proceed with formal adoption of the changes.

(5) Acceleration for a Change in Control. Representatives of the Commissioner of Corporations have said that they believe that a stock option plan or agreement which provides for acceleration of the exercise date in the event of a change in control does not qualify for the exemption under Section 25102(o).

d) Section 25102(f) in California

(1) For equity incentive plans and agreements that do not meet the requirements of Section 25102(o) and do not benefit from federal preemption, the issuer can rely on Section 25102(f), which exempts offers and sales to not more than 35 persons who, either because of their business or financial experience or that of certain professional advisors or their relationship with the issuer or its officers, directors, controlling persons or managers, could reasonably be expected to protect their own interests in connection with the transaction. The 35 person limit does not include an unlimited number of "accredited investors" (as defined in Regulation D) and other categories of purchasers. See Section 260.102.13 of Title 10, California Code of Regulations.

(2) Each purchaser must represent that he or she is purchasing for his or her own account and not with a view to or for sale in connection with any distribution of the security. There can be no publication of any advertising, and a notice is required to be filed (although the failure to file does not affect the availability of the exemption).

4. Getting a Permit. This is done using the normal procedure except that the Commissioner of Corporations can be expected to apply the standards set forth in the regulations referred to above that are applicable in determining whether the Section 25102(o) exemption is available.

The 2nd Annual Spring Meeting BUSINESS LAW SECTION